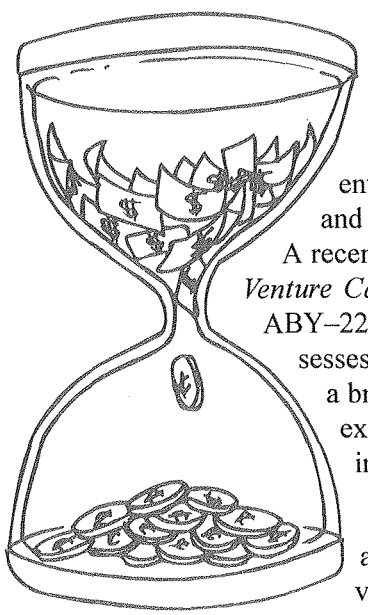
USAID Evaluation News

A Newsletter on Recent Evaluation Findings and Methods

1997 • Vol. 9 • No. 1

Development Experience Review

Equity Investment Projects: Likely to Lose



by James Fox, CDIE

Can equity investment in emerging enterprises reduce poverty and stimulate development? A recent CDIE evaluation, *The Venture Capital Mirage* (PN–ABY–220), by James Fox, assesses that proposition. It takes a broad look at USAID experience with equity investment.

The study examines a dozen USAID projects in venture capital and concludes that such projects have been almost uniformly disappointing, for two reasons: 1) the approach has been flawed, and 2) equity investment is a low-payoff activity for donors. Enterprise funds—more independent entities run, under U.S. auspices, by savvy financiers—have avoided some of the problems asssociated with USAID projects, but have so far produced only mixed results.

In this issue

Why Equity Finance? The Conventional Wisdom

Firms in developing countries need capital if they are to create jobs and raise productivity. Banks lend to firms to expand capacity, but finance has limitations. A borrower from a bank has to repay a fixed amount irrespective of whether the project is a failure or a smashing success. Because the bank's primary concern is repayment, banks use a variety of practices (such as heavy collateral requirements and lending only to large established businesses) that are inherently conservative and oriented to the status quo.

If developing countries are to reduce poverty quickly, some have argued, such conservative approaches are not enough. More innovative investment approaches are needed that broaden the distribution of wealth by financing dynamic, less well-to-do entrepreneurs in high-payoff activities.

Thus, the theory holds, there is a need for *risk capital* to flow to people with ideas and capabilities but without money. In principle, a financier, or *venture capitalist*, should be able to find promising enterprises to back with funding and limited technical advice, perhaps for a considerable period of time.

If the enterprise fails, the financier simply loses the stake. If it succeeds, the financier has acquired a stake that yields benefits in proportion to the company's success. This may be a multiple of the initial investment—at any rate, it should be very high.

The rationale for USAID involvement in venture capital projects has typically been to demonstrate the existence of a profitable market for such financing, thus catalyzing private investment.

USAID's Experience With Venture Capital Projects

USAID has approved 13 projects since 1970 that included at least a component aimed at venture capital or equity investment (see table, page 3). For the eight projects for which solid information is available, the experience was almost uniformly disappointing. Many of the projects made poor investments; nearly all had cost structures that made them unsustainable. Only one of the institutions—the Latin American Agribusiness Development Corporation—has proven clearly sustainable, but this was because it shifted from equity funding to lending.

Four characteristics of USAID projects appear to account for the poor performance:

1. *Choosing the wrong implementer.* USAID usually chose consulting firms, merchant bankers, or commercial banks that in most projects had little or no previous venture capital experience. Venture capitalists were often unwilling to implement USAID projects.

2. *Excessive constraints on the implementer.* Venture capital projects tried to do too much. Some USAID projects limited investments to areas of particular USAID concern—agriculture, very small businesses, women-owned businesses. Finding good investment opportunities in developing countries has proven difficult enough. Further limiting the scope for search or adding goals can make it impossible.

USAID Evaluation News

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USAID–Approved Venture Capital Projects

Year	Country/ Region	Amount* ($ million)	Purpose	Implemented?
1971	Latin America	20.0	Latin American Agribusiness Development	yes
1979	Egypt	1.0	Private Investment Encouragement Fund	no
1982	Haiti	12.0	Establish development finance corporation for lending and venture capital	no
1984	Jamaica	21.2	Grant for Jamaica Agricultural Development Foundation for loans, equity investments	yes
1985	Costa Rica	26.0	Private Investment Corporation for lending, equity	yes
1985	Asia	n.a.	Appropriate Technology, Inc.	yes
1986	Eastern Caribbean	40.0	High-impact agribusiness promotion	yes
1986	Ireland	50.0†	Part of cash transfer for venture capital lending	yes
1987	Thailand	3.0	USAID Private Enterprise Bureau loan to a new venture capital firm	yes
1987	Jordan	0.7	Establish a venture capital fund and other activities	no
1987	Kenya	9.6	Fund two equity capital companies	yes
1988	Sri Lanka	2.4	Launch a venture capital company and other activities	yes
1989	Africa	2.4	Africa Growth Fund for equity investment	yes

* Project amounts are not necessarily for venture capital; in some cases, the USAID funds are used for lending by firms using other funds for venture capital activities.

† Total project; documentation unclear on amount for venture capital activity.

3. *Rigid design.* In some projects, the actual conditions during implementation differed sharply from those anticipated in the design. Adaptation to such changes was generally very slow.

4. *Inadequate demand or poor country environment.* In some cases, there were simply an insufficient number of promising investment opportunities. Even where economic conditions were favorable, entrepreneurs often refused to consider selling equity.

Each of the first three problems is closely linked to the ways in which USAID does business through projects. The fourth problem is generic.

Other Donor Experience

The conceptual attractiveness of venture capital has interested other donors, but their efforts too have met with great difficulties. Perhaps the earliest such effort was the Rockefeller Foundation's International Basic Economy Corporation (IBEC). Established around 1950 with original operations confined to Latin America, IBEC by 1968 was operating in 33 countries. But IBEC found that adverse economic developments in a number of countries hurt its portfolio. It also found management costs were much higher than earnings from its loan and equity portfolios could sustain. IBEC went bankrupt.

Faring slightly better was the multilateral International Finance Corporation, established in 1956 by the World Bank. But the IFC's mandate has always emphasized recoverable *loans* over much riskier equity investments. At the end of 1993, only 16 percent of the IFC's total portfolio was in equities. And the equity portfolio has not turned over very quickly, with an average holding period closer to 20 years than the 5 to 7 typical of venture capitals. Yet other donors, among them the private Atlantic Community Development Group for Latin America and the multilateral Inter-American Investment Corporation, have had similarly lackluster results.

VENTURE CAPITAL

Continued from page 3

Enterprise Funds

In 1989 President George Bush announced the establishment of what he called enterprise funds for Hungary and Poland. The private, nonprofit funds were intended to speed the transition to market economies by supporting the establishment and expansion of private businesses.

The funds had advantages not identified with USAID venture capital projects. The boards of directors, selected by the president, were largely people with substantial financial market experience. The funds were given total freedom of action so they could begin operations quickly and adapt flexibly to changing conditions.

The first four funds, established in 1990–91, provide a basis for assessment. (Seven funds added in 1994 are too new to evaluate.) The creation of the enterprise funds showed U.S. support for the development of viable private sectors in Eastern Europe at a critical juncture, and probably encouraged private investment in the region. Nevertheless, the performance of the funds in equity investment has not been particularly favorable. Two have experienced large losses unlikely to be offset by gains elsewhere in the protfolio. Of the other two, the value of the portfolios appears to have increased only modestly.

The freedom from constraints appears to have produced innovation and flexibility, but it has also brought on mistakes and major errors in judgment. All the funds had difficulty finding equity investments that offered high payoffs. Even the more successful funds have not demonstrated that lack of equity capital is a serious problem that donor funding can solve. This calls into question the basic hypothesis of a severe shortage of equity capital.

The bottom line: donor-financed venture capital projects are likely to be losers. USAID should leave this activity to others.

Making Energy Conservation Work

USAID projects that promote energy conservation have had significant success cutting fuel costs and reducing pollution. But the technologies that yield such benefits have hardly been adopted beyond the small number of companies that participated in USAID demonstration projects. Future efforts will need to do more to foster an environment friendly to widespread investment in energy-efficient technology.

That is the core finding of a recently published CDIE study titled *Shining the Light on Energy Conservation: A Synthesis of Findings From Six Evaluations.* The report, by economist Joseph Lieberson, deputy chief of the center's Program and Operations Assessment Division, is also available in a condensed Evaluation Highlights version.

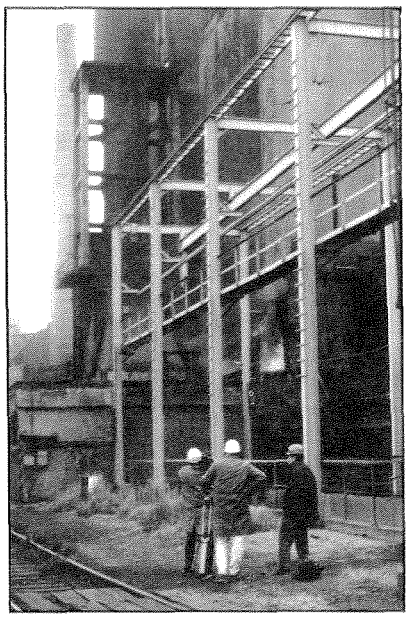

Photo by Donna Woolf

Energy conservation projects in the Czech Republic are among those CDIE studied.

Developing countries, the report observes, are in a race to modernize, a fact not lost on a visitor to almost any developing-country capital. Almost continual traffic gridlock and the sight of factory smokestacks belching pollution are common sights. Those who last explored Bangkok, Cairo, Manila, or Mexico City 10 or 15 years ago are struck by the massive increase in air pollution from automobiles, trucks, and factories.

As development takes hold and growth accelerates, energy use increases dramatically. But in many cases developing countries do not use energy efficiently. They often require two to four times more energy than industrial countries to produce the same output.

This excessive consumption speeds up the accumulation of carbon dioxide, a greenhouse gas, in the atmosphere. In addition, fuel combustion is often dirty and incomplete, generating local pollution.

Shining the Light looks at projects in the Czech Republic, Guatemala, Hungary, Jamaica, Pakistan, and the Philippines. It shows the projects generally benefited participating countries.

The projects' economic rates of return (that is, the flow of benefits, such as reduced fuel costs and cleaner air, less the costs incurred in their generation) ranged from a low of 2–33 percent in Jamaica to a whopping 20–63 percent in the Philippines (see table, page 5).

Economic Rates of Return and Average Payback Periods

Country	Economic Rate of Return (percent)	Average Payback Period (months)
Czech Republic	50	9.8
Guatemala	N.A.	N.A.
Hungary	165	2.4
Jamaica	2–33	N.A.
Pakistan	19–25	24.0
Philippines	20–63	22.0

Individual companies also profited. By reducing fuel consumption, they reduced costs. And the investment in energy-saving technology had a fast payback. Of the four countries for which data are available, the companies broke even, on average, in two years or less. In Hungary the companies recouped their investment in a remarkable 2.4 months.

But once USAID funding ended, technology rarely spread beyond the original demonstration sites. Only a few other plants made similar investments. The obvious question: Why would they elect not to do so?

To answer that question, the synthesis identifies five factors that affect the relative success of USAID energy conservation projects. They are *energy policy, investment and business climate, technology, institutional capacity,* and *education and awareness.*

The study examines how these factors relate to one another and suggests which ones the Agency needs to concentrate on for best results.

Energy Policy

When energy is cheap, little incentive exists to conserve it. Only when factory managers and other major consumers worry about energy as a major cost factor will they strive to use it efficiently.

The countries regarded cheap energy as necessary to encourage investment in machinery—and thus achieve modernization. When international oil prices skyrocketed in the 1970s, governments provided massive subsidies in an attempt to keep domestic energy prices "reasonable." But they could not withstand the strain on a protracted basis. Eventually they threw in the towel, letting energy prices rise to world levels. And beginning in the late 1980s, governments in many countries took steps to privatize state-owned factories. With state ownership, cost concerns were subordinated to such objectives as maintaining full production and full employment. With privatization, costs became a prime factor in planning—and using energy efficiently cut costs.

Investment and Business Climate

Energy conservation measures are, before all else, business investments. An energy-conservation program may be effective at reaching clients, and the technology may be sound, but if business managers are unwilling to invest, nothing is gained.

And businessmen are a cautious lot. Business attitudes develop over many years and change slowly. Even with the right policies in place, business managers may still take a wait-and-see attitude. The reason: political and economic uncertainty. An uncertain climate will deter long-term investments in energy conservation.

Technology Transfer

To the extent the projects succeeded, they did so by promoting relatively simple energy-saving technology and emphasizing ways to make existing equipment work more efficiently. Technologies were simple, not revolutionary, and almost always based on standard "off the shelf" equipment available from a number of different manufacturers. More sophisticated technologies were less successful.

Institutional Capacity

Developing market-driven institutions that are entrepreneurial and responsive to market needs is critical to project success. Institutions are the glue that holds together the various actors in energy conservation. Each project took a slightly different approach to institutional development. As a whole, public sector approaches were less encouraging than those aimed at the private sector or nongovernmental organizations. Public sector institutions had difficulty designing cost-effective education and training programs that met the need of private firms. They showed little promise of being able to sustain themselves after assistance ended. And they are not well attuned to changing markets, new technologies, and maximizing profits.

Energy Education And Awareness

Good energy technology is not enough; effective and continual dissemination is also needed. As long as USAID projects were being implemented and energy seminars and promotional activities were in full swing, firms were interested in energy conservation. But once projects ended and promotional activities wound down, awareness and interest dropped off sharply.

However, if energy policies are bad and institutions are weak, education and awareness campaigns are of no use. Success depends on having in place incentives, financing, supporting institutions, realistic energy prices, and cost-conscious factory owners who have a stake in making a profit.

In sum, developing countries need the energy-saving technology USAID has to offer. Countries and individual companies alike benefit financially, with a free bonus of reduced air pollution. To make its projects broadly successful, though, the Agency needs to pay greater attention to promoting adoption of policy incentives, developing institutions, and spreading the word about the advantages of saving energy.

Evaluation Methods

Reengineering Best Practices Series Gets Under Way

What's hot in reengineering? What works and what doesn't? A new CDIE series, Reengineering Best Practices, captures the best of USAID's experiences in implementing reengineering in both the field and in Washington. The papers provide frank discussions on implementing reengineering concepts and provide lessons learned. CDIE welcomes submissions from individuals or operating units that would like to share their experience with others in the Agency.

Papers available include

1. *Country Experimental Labs: One Year Later,* synthesizes CEL reports from April 1995 to January 1996 and describes CEL experiences in implementing the core values. The report contains many ideas for other operating units, raises issues, and outlines lessons learned by CELs to date. (Order number PN–ABY–270)

2. *Building Teamwork in USAID's Dominican Republic Mission* is based on a visit by the Training Resources Group to USAID/Dominican Republic in May 1995 to help the Mission form and train strategic objective teams. The report outlines the team-building approach used in the workshop, lists new skills and attitudes required for teamwork, describes how leadership roles were defined, and makes recommendations for successful teamwork applicable to all USAID Missions. (Order number PN–ABY–271)

3. *Reengineering at USAID/Bolivia: Why We Did What We Did* is one Mission's account of undertaking reengineering. It tells how staff overcame initial apprehensions and carried out the first transition tasks. It discusses what training approach they followed, their achievements, and the continuing challenges. The report provides ideas and an understanding of what's involved in initiating reengineering in a field Mission. (PN–ABY–272)

4. *A Partner's Consultation: Reengineering Relations.* This paper covers USAID/Philippines' experience with transforming a traditional annual conference with its NGO grantees into an exciting partner consultation. Applying reengineering principles of participation and customer focus, USAID/Philippines found it benefited by shifting from a traditional to an innovative partners' consultation. (PN–ABY–223)

5. *Planning and Managing for Results Under Reengineering: Early Lessons From the Field* summarizes challenges and practical questions Missions face in reengineering the way they do business. It looks in particular at working in teams and working with customers and partners. Drawing on field visits and seminar discussions held in Washington in June 1996, the paper raises issues to be resolved and priorities for senior management support and guidance. (PN–ABY–228)

A more detailed review and analysis of the Missions visited appears in the CDIE Working Paper *Planning and Managing for Results With Teams, Customers, and Partners in the Reengineered USAID: Observations From the Field.* (PN–ABY–229)

6. *Managing for Results in a Regional Mission: USAID/Central Asia's Experience.* This report shares the experience of a regional Mission managing five country programs under the Freedom Support Act. While the Mission sees real benefits in a regional approach, it found that regional management is staff-intensive and requires careful monitoring of partners working under the broad mandate of regional or worldwide grants or contracts. (PN–ABY–231)

How to Order

These Reengineering Best Practices reports can be ordered in paper or electronic format.

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Staff with access to the Internet can obtain the reports electronically from the Agency's internal Web site. Start by accessing the Internet address www.usaid.gov. From the Agency's corporate Web home page, click on the button CDIE ONLINE. To access the Reengineering Best Practices papers, click on CDIE NEWSLETTERS, BULLETINS, AND BIBLIOGRAPHIES from the CDIE Online home page.

Contributing to the Series

Missions and USAID/Washington units are encouraged to share their reengineering experience with colleagues through the Reengineering Best Practices series. Both successful experiences and less-than-successful experiences that produce useful lessons learned are valuable.

Before submitting a paper to be considered for the Reengineering Best Practices series, please provide a one- or two-page summary for the interbureau review group. Send your summary to Joan Silver, Senior Policy Adviser, at PPC/CDIE/FO, Rm. 308-P, SA-18, or send via e-mail attachment.

News

CDIE Publishes Own Home Page

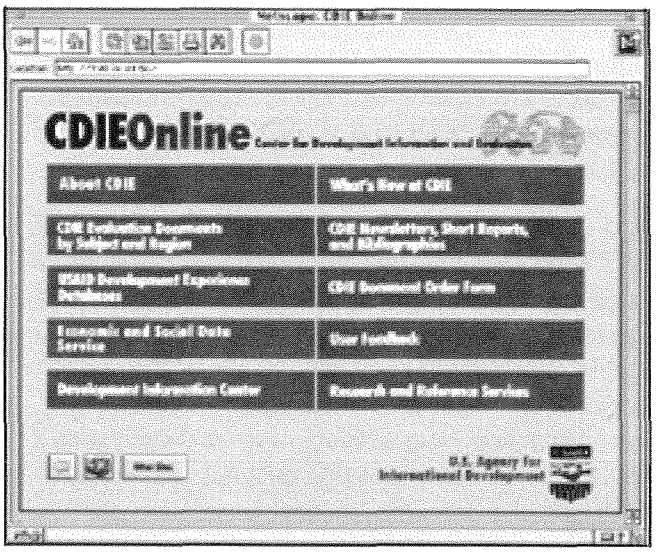
CDIE's new corporate web home page, CDIE Online, seeks to better inform Agency decision-making by providing lessons from experience in an easy-to-use vehicle. Though currently available only within the Agency through the corporate web, the home page should become available to Internet users later this year.

Through the home page, CDIE can disseminate its broad range of development information, including evaluation results, lessons learned, development experience, and socioeconomic data. Customers can submit requests for CDIE services and give feedback.

Users access the CDIE home page through USAID's corporate web home page at http://www.usaid.gov using Netscape. Click on the blue INFORMATION SERVICES button, then click on the blue CDIE ON-LINE button. USAID staff can access information on the CDIE Online home page by selecting various options.

"About CDIE" covers basic information about CDIE, including a description of its administrative organization, functions, mission, and an organizational chart. "What's New at CDIE" contains the most current information resources and services, and CDIE publications released in the last four months. In "CDIE Evaluation Documents," users can search for and view abstracts or full text of recent CDIE evaluations. The documents are organized by subject (such as economic growth, population and health, natural resources), and by subtopic.

"CDIE Newsletters, Short Reports, and Bibliographies" offers a variety of CDIE publications. Among them are topical, annotated bibliographies, Evaluation Highlights, Reengineering Best Practices, Performance Monitoring and Evaluation Tips, and the most recent Agency Performance Report. Users clicking on "USAID Development Experience Databases" can search citations to more than 90,000 planning, evaluation, and research documents. The electronic full text for selected CDIE evaluations and other recent Agency reports are gradually being added for on-line viewing or downloading. Users can conduct their own searches by subject, date, country, title, or other selected search fields. They can also request research assistance from CDIE. Users can request USAID documents on-line by filling out an electronic order form.



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The "Economic and Social Data Service" site provides datasets organized by category: democracy and civil society; economic assistance; economic growth; environment and natural resources; humanitarian assistance; and population, health, and nutrition.

Until the CDIE Internet site comes on-line later this year, public users will be able to access selected Agency publications and reports through the USAID Internet Web site: http://www.info.usaid.gov.